

Giving Through Retirement Plans

Tax legislation in recent years has included significant changes in the area of tax-preferred retirement plans. For example, in the Taxpayer Relief Act of 1997, the Roth IRA was introduced. This plan allows a taxpayer to make contributions of after-tax dollars to an IRA. The funds build tax-free and may be withdrawn tax-free at times specified by the act. This plan may be especially advantageous to certain taxpayers. As the proceeds from such plans will not be income in respect of a decedent, it would in most cases be wise to make charitable dispositions from other types of IRAs or qualified plans that would generate income tax liability if received by heirs.

In an important move, in 1997 Congress also removed the 15% excise tax on what were known as excess accumulations or distributions under the terms of prior legislation. This eliminated a major disincentive for people who wished to accumulate large sums in their tax-favored plans.

Tax legislation enacted in 2001 provided for increases in the amount that people could contribute to retirement plans over time, along with “catch-up” provisions for those over age 50. These changes should result in more funds accumulating in such accounts over time.

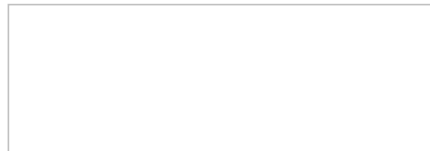
The Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which Congress passed in conjunction with the [Emergency Economic Stabilization Act of 2008](#), renewed incentives allowing donors over age 70½ to make tax-free gifts to charitable interests from a traditional or Roth IRA.

Effective gifts from tax-qualified plans

From a tax planning perspective, one of the most efficient ways to leave a gift to a charitable interest at death may be through a traditional Individual Retirement Account (IRA) or other tax-deferred qualified retirement plan.

Example: Joan, a widow, 75, plans to leave her \$100,000 IRA to her granddaughter, Ellen. The IRA balance may be subject to estate taxes (at an assumed rate of 45%) and state and federal income taxes (at an assumed rate of 35%).

Here is a simplified example for Ellen:



As one can see, Ellen may eventually receive only 36% of the IRA balance.

Why are these funds subject to both estate and income taxes? Because qualified retirement fund balances are considered “income in respect of a decedent” (IRD) under [Internal Revenue Code section 691](#). (Note that section 691(c) provides for an income tax deduction for estate tax attributable to IRD.)

Joan, on the other hand, could leave the \$100,000 in the IRA directly to one or more charitable interests free of all income and estate taxes. There would be no federal estate tax because of the estate tax charitable deduction and no income tax because of the charitable organization’s exemption from income taxes.

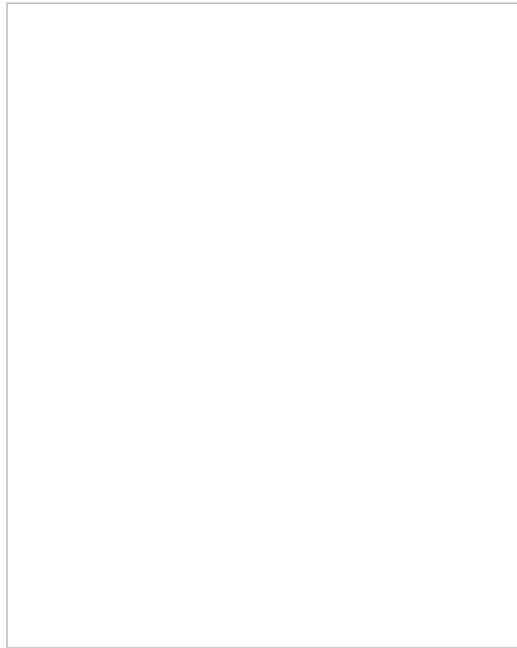
If Joan wished to leave bequests to both Ellen and her charitable interest(s), it would thus be better for Ellen to receive assets other than the IRA balance, with the gift to charity through the IRA. This way, Ellen’s inheritance would possibly be subject to estate tax, but not income tax.

Other tax rules on IRA distributions

It is perhaps prudent to focus on the IRA as a retirement plan around which estate planning is done, because so many retirees are choosing to roll pension, 401(k), and other retirement moneys over into IRAs. This is because a rollover affords more control to the retiree and can be made without immediate taxation.

Required beginning distribution date (“required beginning date”): IRA distributions must begin by April 1 of the year following the year in which the IRA owner turns age 70½. IRA distributions may begin earlier, although distributions made to the IRA owner before he or she turns 59½ are subject to regular income tax unless made (1) on account of a qualified disability, (2) in the form of a life annuity, (3) on account of retirement after age 55, or (4) in certain other circumstances (see [IRC section 72\(t\)](#)). Unless as noted previously, such early distributions prior to age 59½ are subject to a 10% additional tax.

Minimum distributions: Individuals often find it desirable to keep money in an IRA for as long as possible in order to take advantage of the IRA’s tax-exempt status. In this case, the IRA owner may not wish to take withdrawals from the IRA before reaching age 70½ and then, upon reaching the required beginning date following age 70½, take as little out of the IRA as required by federal tax law.



In regulations released in 2002, the Internal Revenue Service finalized new rules for determining the amount of required distributions from qualified retirement plans. The new regulations, which became mandatory on January 1, 2003, simplified the rules for determining required minimum distributions.

Under the regulations, the table on page 13 is used to determine the distribution rate for each age. For example, at age 71, the required minimum distribution rate is (1/26.5), or approximately 3.8%. The next year, when the retiree attains age 72, the required minimum distribution rate is (1/25.6), or approximately 3.9%.

The distribution rate is applied to the value of the IRA (or other plan) balance as of the end of the year immediately preceding the distribution year. A married plan owner whose spouse is more than 10 years younger can use the other appropriate IRS tables to calculate minimum required distributions. This rule is based on the fact that the life expectancies in the table set out under the 2002 regulations are based on two lives with a 10-year age difference.

Designated beneficiary: If a plan has a designated beneficiary, the beneficiary uses the table under the 2002 regulation to figure his or her minimum required distributions. In the case of a non-spouse beneficiary, minimum distributions must commence by December 31 of the year immediately following the year in which the plan owner died. In the case of a spousal beneficiary, the spouse may wait until whichever is later to begin taking minimum distributions—December 31 of the year immediately following the year in which the plan owner died or December 31 of the year in which the plan owner would have attained age 70½ (i.e., when the plan owner dies before age 70½).

A surviving spouse who is the sole beneficiary generally may elect to treat the IRA as his or her own, which may permit minimum distributions to be deferred further.

If there is no designated beneficiary, the entire plan balance must be distributed within five years after the plan owner’s death. The determination of whether there is a designated beneficiary is made as of September 30 of the year immediately following the year of the plan owner’s death.

Providing for charity: The term designated beneficiary is a technical term that basically includes only

individuals. An irrevocable trust that meets certain requirements can also be a designated beneficiary. Although a charity can be a beneficiary, it cannot be a designated beneficiary. Neither can a charitable remainder trust (CRT). Nor can any of multiple beneficiaries if any one of them is a charity or a CRT. If, however, the plan owner names both a charity (or a CRT) and an individual as beneficiaries and the distribution to the charity (or CRT) is made before the date for determining whether there is a designated beneficiary, the individual beneficiary will be considered a designated beneficiary.

Spousal rollover: If the surviving spouse of an IRA owner receives a lump-sum distribution from the IRA, the surviving spouse generally may roll the distribution over into his or her own IRA tax-free within 60 days of receipt.

Making gifts from retirement accounts during lifetime

Any funds withdrawn from an IRA or other tax-favored retirement plan (other than Roth IRAs) during life will normally be subject to income tax. If the funds are then donated for charitable use, there is an offsetting charitable income tax deduction and the transaction is generally a “wash” for tax purposes. Careful consideration should be given to limitations of deductions based on adjusted gross income and other provisions of the Code that can act to reduce the amount of deductions in certain circumstances. The impact of state law should also be considered.

In years when individuals are facing requirements to withdraw funds from an IRA or other tax-favored retirement account in excess of what they currently need to fund living expenses, they may consider making special gifts to fulfill charitable commitments utilizing the withdrawal amounts. If they have highly appreciated securities, they may wish to use those assets to fund their gifts, while using cash from the withdrawal to make new investments at a higher cost basis for tax purposes.

As part of H.R. 4, the Pension Protection Act of 2006 (PPA), Congress enacted a number of charitable giving incentives and reforms. Insofar as gifts from retirement accounts are concerned, the PPA made an exception to the law outlined above and provided that individuals over the age of 70½ could direct that a total of up to \$100,000 per year be distributed from their traditional or Roth IRA directly to an organization described in [IRC section 170\(b\)\(1\)\(A\)](#) (other than an organization described in section 509(a)(3)) or a donor advised fund (as defined in [IRC section 4966\(d\)\(2\)](#)). The exception applied only to distributions completed in 2006 and 2007. In October 2008, in conjunction with the [Emergency Economic Stabilization Act of 2008](#), Congress passed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which extended the PPA rollover provisions to cover gifts completed in 2008 and 2009.

To qualify, the distribution must be made by the IRA trustee to the charitable recipient and must be otherwise fully deductible. Distributions to fund charitable gift annuities, charitable remainder trusts, and other split-interest gifts do not qualify.

Amounts transferred in this manner are not included in a taxpayer’s adjusted gross income (AGI), but will be counted as part of a mandatory withdrawal. This can hold special advantages for donors who would otherwise exceed 50% of AGI limits on their gifts or experience other adverse tax consequences that would keep their gift from being a complete wash for tax purposes. Some taxpayers may wish to roll amounts from other types of retirement accounts to an IRA in order to take advantage of this opportunity.

For a complete explanation of the law, see the [Joint Committee on Taxation explanation of H.R.4](#).

Other planning options

Here is a brief look at some other charitable gift planning opportunities with IRAs.

Rollover IRAs: If a donor leaves IRA money in a lump sum to his or her spouse, who then rolls the money over into the spouse’s own IRA, it may make sense to provide for all or part of the money remaining in the rollover IRA at the spouse’s death to go to charity.

QTIP trust: It is possible, subject to certain requirements, to make the QTIP election with respect to both an IRA and a trust named as beneficiary of the IRA. See [Rev. Rul. 2000-2](#). In this case, it may be desirable to provide that part or all of any principal remaining in the trust at the surviving spouse’s death goes to charity.

Rollover to charitable trusts: As of December 31, 2007, federal tax law does not afford any means of rolling money out of an IRA or other tax-qualified retirement plan account during lifetime directly to a trust or other split-interest charitable gift without the account owner having to report the money as income for federal income tax purposes.

A charitably motivated individual might, however, want to withdraw money from his or her IRA today, place part of the money in a charitable remainder trust (or other charitable “life income” arrangement) to provide a retirement income, and use the remainder of the money to pay tax on the withdrawal. In this case, the charitable deduction with respect to the trust will help reduce but not eliminate the tax owed.

Designating a charitable remainder trust as beneficiary: While tax-free transfers from IRAs to trusts and other split-interest gifts are not possible during lifetime, it is possible to name a charitable remainder trust (CRT) to receive the balance of an IRA at death. In this case, the money is not subject to income tax on the transfer from the IRA to the CRT because of the CRT’s tax exemption under [IRC section 664\(c\)](#). The individual beneficiary of the CRT simply pays income tax on the distributions he or she receives from the trust.

Upon the transfer from the IRA to the CRT, an estate tax charitable deduction is allowed for the anticipated value of the remainder interest in the trust.

When IRA assets are left at death to a CRT, a question arises: What becomes of the income tax deduction under Code section 691(c) for estate tax attributable to income in respect of a decedent (IRD)? In [Letter Ruling 199901023](#), the IRS said the deduction was allocated to the CRT and was used to reduce the amount of “first-tier income” (ordinary income) for trust income tax accounting purposes. As estate tax exemptions increase over time, planning for estate tax consequences of establishing a CRT at death will be less of a consideration for many. Several legislative proposals have been made to simplify the process of making outright and deferred gifts using retirement plan assets. Donors and advisors should always check for latest statutes and regulations prior to completing gifts in this manner.

Other relevant rulings: In [Letter Ruling 9237020](#), the IRS considered a proposal to leave residual IRA money at the IRA owner’s death to a charitable remainder unitrust, which would make payments to the IRA owner’s son for a term of 20 years and then distribute all of its assets to charity.

The IRS ruled that the IRA money would not be subject to income tax as it rolled out of the IRA into the unitrust because of the trust’s exemption from income taxes under [IRC section 664\(c\)](#). The IRS also ruled that the IRA money rolling into the unitrust would qualify under the usual rules for the federal estate tax charitable deduction.

In [Letter Ruling 9253055](#), the IRS took the same basic position with respect to a proposal to leave, at death, residual money in a corporate retirement plan account to a unitrust for the benefit of the donor/employee’s spouse. This ruling stated that the wife’s interest in the unitrust would qualify for the federal estate tax marital deduction.

This type of plan can make sense for the charitably motivated person who (1) wants to shield residual IRA or other retirement plan money from what may seem to be punitive estate and income taxes; (2) wants to provide an income to a family member; and (3) likes the idea of outlining the use of any remaining funds at the termination of the trust.

For further reading, see also from the Planned Giving Design Center:

Articles:

- [Treacherous Waters](#)
- [The Pension Protection Act of 2006: A Guide to Charitable IRA Rollovers](#)
- [IRA Rollover Extension Included in Financial Rescue Bill](#)
- [Charitable Planning With Lump Sum Distributions](#)

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